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World Economic and Social Survey 2008: Overcoming Economic Insecurity

Overview

Summary

Economic insecurity arises from the exposure of individuals, communities and countries to adverse events, and from their inability to cope with and recover from the downside losses. The attention brought to the presence of heightened economic risks and compounded threats has often been met with the response that the forces behind them are autonomous and irresistible, and beyond our collective political control. The *2008 World Economic and Social Survey* offers a different perspective. A strong "social contract" is needed to secure the spaces within which individuals, households and communities can pursue their day-to-day activities with a reasonable degree of predictability and stability, and with due regard for the aims and interests of others.

More space is needed for conducting counter-cyclical macroeconomic policies and securing greater international support for broader social protection schemes. This will also require a better link between approaches to local disaster management and development strategies. Indeed, dealing with economic insecurity in post-conflict situations requires radically different approaches in the provisioning of aid and in the conduction of macroeconomic and social policies.

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Insecurity spreads

When the Berlin Wall collapsed in 1989, the talk was of an emerging era — an era of widespread peace, prosperity and stability, thanks to the spread of democratic values and market forces. Bank runs, plummeting house prices, gyrating currencies, food riots, election violence, ethnic carnage — to name just some of the phenomena that have dominated the international news media over the past 12 months — were certainly not to be a part of its future.

In a poll undertaken earlier this year in 34 countries for the BBC World Service, the unchecked pace of globalization and the unfair distribution of its benefits and damages emerged as widely shared concerns. Similar findings have been reported by the Pew Foundation and the German Marshall Fund, among others. Survey evidence is no substitute for careful analysis. Still, it does highlight a growing sense of unease over the economic course that has been charted in recent years.

This unease has emerged strongly in advanced countries where increased economic insecurity has been associated with rising inequality and the squeezing of social provisioning. In middle-income countries, economic shocks, accelerated trade liberalization and premature deindustrialization have constrained economic diversification and formal job creation. In still other places, intractable poverty has fed a vicious circle of economic insecurity and political instability and, on occasion, ferocious communal violence.

These concerns have been compounded by new global threats. Climate change has become the defining generational challenge for the international community. Several increasingly destructive natural disasters have provided tangible evidence of the threat that this poses for economic livelihoods in rich and poor countries alike. Unstable financial markets and volatile capital flows are currently threatening economic livelihoods across the world economy owing to their adverse impact on productive investment, economic growth and job creation. Since early 2008, a growing mismatch between the supply of and demand for agricultural products has triggered serious political unrest in a number of countries and put the issue of food security back in the international agenda.

The attention brought to the presence of these heightened economic risks and compounded threats has often been met with the response that the forces behind them are autonomous and irresistible, and beyond our collective political control. The call invariably has been to cast aside old institutions and loyalties and embrace the new and efficient market practices of a borderless world. The *World Economic and Social Survey 2008* argues that this is the wrong response to increasing levels of economic insecurity. It calls instead for more active policy responses to help communities better manage these new risks, increased investment in preventing threatening events from emerging and more concerted efforts to strengthen the underlying social contracts which are, in the end, the real basis of a more secure, stable and just future.

The myth of the self-regulating market

The self-regulating market was the idée fixe of the late twentieth century. Freeing markets promised to unleash the wealth-creating forces of unrestricted

competition and risk-taking, as well as to ensure that the resulting prosperity would be inclusive and the outcome stable. A more flexible workforce, greater asset ownership and easier access to financial markets would help households better respond to market signals and smooth incomes as well as consumption over time. Greater security would naturally follow.

Pushing this idea was always a gamble. At least since Adam Smith, careful observers have understood that markets do not regulate themselves, but depend on an array of institutions, rules, regulations and norms which help moderate their more destructive impulses, mediate possible tensions and conflicts that normally arise and facilitate peaceful bargaining over how the gains and losses from risk-taking activities are to be distributed.

The pioneers of the post-1945 mixed economy had been persuaded by the experience of the interwar years that unregulated markets were more prone to self-destruction than to self-regulation. Idle tools, wasted wealth, wretchedness and, ultimately, political strife proved too high a price to pay for stable money and flexible markets. Their stated goal was a "new deal" which would satisfy the "craving for security" without extinguishing the creative impulses generated by the market economy. Full employment would be achieved through active macroeconomic management, public goods would be provided through a larger fiscal base and markets would become a more dependable source of wealth creation through an appropriate mixture of incentives and regulation. Moreover, given the close economic ties among countries, the new consensus would have an international dimension to ensure that trade and capital flows complemented these objectives.

Dismantling the checks and balances that emerged with this consensus has proceeded at an uneven pace among the advanced countries and has often been more enthusiastically embraced in the developing world and in transition economies, where "shock therapies" promised rapid and positive effects. As part of a global trend, many of the stresses and burdens of unregulated markets have been unloaded onto individuals and households, and with diminished or only limited offsetting government responses. This has been described, with reference to the United States of America, as the "great risk shift".

Security matters

It is not easy to give a precise meaning to the term economic insecurity, partly because it often draws on comparisons with past experiences and practices, which have a tendency to be viewed through rose-tinted lenses, and also because security has a large subjective or psychological component linked to feelings of anxiety and safety, which draw heavily on personal circumstances. Still, in general terms, economic insecurity arises from the exposure of individuals, communities and countries to adverse events, and from their inability to cope with and recover from the costly consequences of those events.

Sixty years ago, the Universal Declaration of Human Rights[1] declared:

[1] General Assembly resolution 217 A (III).

> Everyone has the right to a standard of living adequate for the health and well-being of himself and of his family, including food, clothing, housing and medical care and necessary social services, and the right to security in the event of unemployment, sickness, disability, widowhood, old age or other lack of livelihood in circumstances beyond his control.[2]

In trying to gauge the possible damage from these sources of insecurity, economists have distinguished between *idiosyncratic risks*, generated by individual and isolated events such as an illness, an accident or a crime, and *covariant risks*, which are attached to events that hit a large number of people simultaneously, such as an economic shock or climatic hazard, and often involve multiple and compounding costs.

Finding the right mix of informal, market and social measures to help citizens cope with and recover from these events, which has been a long-standing policy challenge, has essentially meant weighing up the advantages of pooling the risks against the offsetting administrative and behavioural costs (moral hazard) that this can produce. Such an approach is easier when the threat is small and reasonably predictable: precautionary savings, or spreading the risk through insurance contracts, can often suffice, particularly in response to idiosyncratic threats. The fact that covariant risks, which carry significant negative spillovers, are more difficult to manage in this way has led to various forms of social insurance and assistance.

In most advanced countries, a mixture of public and private mechanisms has been used to ensure maximum coverage and protection. In poorer countries, the mix of options is much more limited, with greater reliance on informal mechanisms such as family support or moneylenders. Expanding those options of risk management has received greater attention from the policy community in recent years.

However, managing risk does not exhaust the insecurity challenge, owing to the fact that, for many of the events that threaten downside losses, the causes are more systemic in nature, and the outcomes can be catastrophic. Such events are much more difficult to predict and to cope with. This is true, for example, of economic crises but much the same can be said of natural disasters and political conflicts. Such threats are the topic of this year's *World Economic and Social Survey*.

It is primarily the responsibility of national Governments to address these threats by removing underlying vulnerabilities, greatly reducing the exposure of households and communities, and supporting their recovery if disaster does strike. Such an effort requires not only undertaking significant investment in prevention, preparation and mitigation measures but also filling the public domain with a dense network of institutions — arising from a social contract — that can secure spaces in which individuals, households, firms and communities are able to pursue their day-to-day activities with a reasonable degree of predictability and stability, and with due regard for the aims and interests of others. This is particularly vital in societies with an increasingly complex division of labour, where high levels of trust, long-term investments in physical, human and social capital and openness to innovation and change are key ingredients of long-term prosperity and stability. In this respect, providing economic security is a complementary component of any virtuous circle involving creative markets and inclusive political structures.

[2] Ibid., article 25, para. 1.

Establishing such positive interaction appears to have become much more difficult in recent years and in some cases has even gone into reverse.

Globalization and economic insecurity

Trade shocks

Few dispute that increased international trade can be a means to achieve greater national wealth. However, for some of those required to adjust to a more open economy, it can also be a source of insecurity. Policymakers in advanced countries have long recognized that increased trade has two faces and have long debated what to do about this, especially in terms of compensating the losers.

Recently, the debate has focused on "offshoring" manufacturing and service activities to lower-cost locations, leaving only core competencies at home. The process has its roots in the early 1970s, but its acceleration in recent years has coincided with the coming on tap of vast new sources of labour in the developing world, particularly in China and India, and with the proliferation of trade and investment agreements involving developed and developing countries.

The evidence does suggest that this wave of globalization has raised worker vulnerability in the industrialized countries, heightening inequality between high- and low-skill workers, dampening employment growth and lowering the overall share of wages in national income. However, these trends pre-date the recent rise in offshoring and point to other, more significant sources of rising labour-market insecurity. Just as important is the fact that increased vulnerability does not translate directly into greater economic insecurity, which depends on whether or not effective institutional supports and national policies are available to reduce and absorb the risk of sudden employment loss and provide alternative sources of income.

Managing trade pressures, however, is not the sole problem of policymakers in advanced countries. Indeed, the flip side of the offshoring of jobs by multinational companies is often low value added and unstable assembly jobs in emerging markets. Many of these countries have been trading much more in recent years, but earning less from doing so, thanks to a combination of greater capital mobility, heightened competition in labour-intensive activities and flexible markets. The fact that, all too often, such production still takes place in enclaves with the shallowest of linkages with the surrounding economy can leave them exposed to unexpected shocks if firms decide to run down or shift the activity.

Trade shocks are an even bigger challenge in countries reliant on more traditional export sectors. The contrast between East Asia and other regions is striking. The share of primary products and resource-based and low-technology manufacturing in the total exports of East Asia declined from 76 per cent in 1980 to 35 per cent in 2005. China alone reduced its share from 93 per cent in 1985 to 44 per cent in 2005. Other regions have been less successful in transforming the structure of their production for exports. South America and Central America still rely on primary products and simple manufactures (about 78 per cent of exports in 2005, down from about 90 per cent in 1983). In Africa, the concentration of exports in low value added products is even greater (83 per cent in 2005).

For many countries in Latin America and Africa, the overall impact of terms-of-trade shocks over the period 1980-2005 was negative, with a brief reversal in the second half of the 1990s, when some countries benefited from favourable movements, and again since 2003. International trade, in that sense, continues to be a major source of instability in countries with weakly diversified economies. Moreover, in some of these regions, notably Latin America, capital-account liberalization has greatly amplified trade shocks by attracting pro-cyclical capital flows. The vulnerability that this can generate was clearly demonstrated in the abrupt reversal of the net transfer of resources following the East Asian financial crisis of the late 1990s.

Policymakers have long sought ways to manage international trade in order to maximize the benefits and limit the costs. Success cases have never relied solely on trade liberalization. Offshoring in the advanced countries and trade shocks in the developing world point to a worrying shift in underlying macroeconomic conditions which has made success all the more difficult, though recent terms-of-trade gains have obscured these problems.

Unleashing global finance

Significant underlying changes in the operation of market economies have been occurring in recent years in all countries. In particular, the weight and influence of financial markets, financial actors and financial institutions have grown dramatically in recent years. This has been accompanied by a massive accumulation of financial assets and by a variety of institutional innovations that have supported growing levels of debt in the household, corporate and public sectors. In some countries, domestic financial debt as a share of gross domestic product (GDP) has risen four- or fivefold since the early 1980s. This process of "financialization" has, in turn, helped to entrench a singular macroeconomic policy focus on fighting inflationary threats.

In the decades following 1945, the business cycle was mainly driven by investment and export demand and underpinned by strong wage growth which fed into high levels of consumer spending. This was not always a stable process. Levels of volatility were often quite high, and wages, profits and tax revenues would often outpace productivity growth, leading to inflationary pressures, current-account deficits and rising indebtedness. These trends signalled to policymakers that action needed to be taken, oftentimes ending in cyclical downturn.

This pattern has been changing as debt, leverage, collateral value and expected asset prices have become dominant drivers of the cycle. The growing tendency of the financial system, including international capital flows, to assume a strongly pro-cyclical stance is a reflection of the fact that asset prices are driven not so much by improved prospects of income gains or losses as by expectations of price changes. This development derives mainly from the pro-cyclical risk attitudes of lenders and investors, underestimated in the upswing and overestimated in the downturn — attitudes encouraged by financial innovations that promise security against downside risks.

Financial booms often give rise to lopsided investments, which often involve little more than rearranging existing assets through leveraged buyouts, stock buy-backs and mergers and acquisitions, or are carried out in sectors susceptible to

speculative influences, such as property markets. Unlike earlier cycles, these booms have delivered few benefits in terms of rising wages and employment. However, increased access of households to credit has meant that consumer spending can increase, even with stagnant incomes, as (rising) levels of indebtedness substitute for (falling) household savings. But as balance sheets adopt smaller margins of safety, the system becomes more and more fragile.

The shift from an income-constrained to an asset-backed economy has been supported by the liberalization of international capital markets. Indeed, the links between domestic financial markets and capital flows are much stronger in developing countries, many of which opened their capital accounts prematurely in the 1990s.

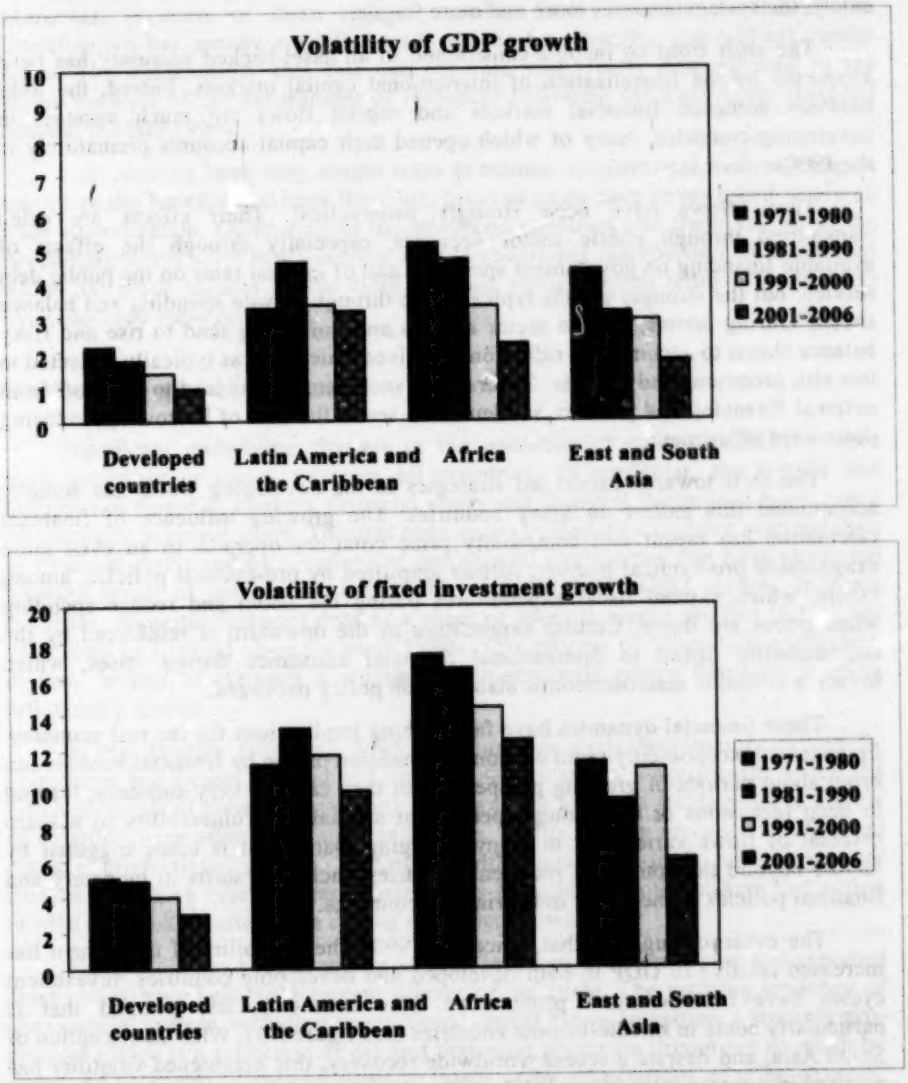
These flows have been strongly pro-cyclical. Their effects are often transmitted through public sector accounts, especially through the effects of available financing on government spending, and of interest rates on the public debt service; but the stronger effects typically run through private spending and balance sheets. During booms, private sector deficits and borrowing tend to rise and risky balance sheets to accumulate, riding on perceived "success", as typically reflected in low risk premiums and spreads. Reversals in such perceptions lead to a cut-off from external financing and provoke sudden increases in the cost of borrowing, inducing downward adjustment.

The shift towards export-led strategies in the developing world has actually accentuated this pattern in many countries. The growing influence of financial calculation has meant that commodity price volatility operates in an even more exaggerated pro-cyclical manner, further amplified by pro-cyclical policies, among others, which expand fiscal expenditures during the boom and reduce spending when prices are down. Cutting expenditure in the downturn is reinforced by the conditionality linked to international financial assistance during crises, which involves orthodox macroeconomic stabilization policy packages.

These financial dynamics have far-reaching implications for the real economy. Episodes of exceptionally rapid economic expansion driven by financial bubbles can bring about periods of growing prosperity, but they can end very suddenly, leading to deep recessions or even longer periods of stagnation. Vulnerability to a sharp reversal of flows varies, but in many emerging markets, it is often triggered by factors beyond the control of recipient countries, including shifts in monetary and financial policies in the major industrialized countries.

The evidence suggests that, since the 1990s, the instability of investment has increased relative to GDP in both developed and developing countries. Investment cycles have become more pronounced than income cycles, a trend that is particularly acute in middle-income countries (see figure 0.1). With the exception of South Asia, and despite a recent worldwide recovery, this heightened volatility has resulted in average rates of capital formation that are still well below those enjoyed in the 1970s. Infrastructure investment and additional manufacturing capacity, both critical to improving the resilience of countries against external shocks, appear to have been hardest hit.

Figure 0.1
Volatility of output and fixed investment growth, developed countries, Latin America and the Caribbean, Africa and East and South Asia, 1971-2006 (Standard deviation of growth rates)



Source: UN/DESA, based on United Nations Statistics Division, National Accounts Main Aggregates database.

Moreover, losses of investment, employment and income incurred during recessions are not fully recovered when the economy turns up, pulling down the longer-term average. The rise of the financial sector has, in many countries, also gone hand in hand with more flexible hiring practices. All of these factors spell considerable income and job insecurity, even under conditions of relatively strong

expansion, a clear sign of which has been the failure in the majority of advanced industrialized countries of the growth of labour compensation to keep pace with labour productivity, although the same trend has been apparent in emerging markets as well.

This can frequently lead to countries' appearing successful, even when the majority of their citizens are not seeing rising standards of living. Oftentimes, the flip side of this development is rising levels of income inequality. The combination of rising insecurity and inequality is one facet of what some have described as "a new gilded age".

Managing the business cycle

Adverse external shocks transmitted through the trade and capital accounts have direct impacts on economic security and the fight against poverty, whether through wasted resources or lost output. During the 1980s and 1990s, many developing countries tried to mitigate the impacts of these shocks with policies that emphasized controlling inflation and restoring fiscal balance. This not only delayed the recovery, but has, in many cases, made it weaker and more vulnerable to future shocks. A different approach is required.

The need for counter-cyclical macroeconomic policies

Governments can enhance the scope for counter-cyclical policies by improving the institutional framework for macroeconomic policymaking. Setting fiscal targets that are independent of short-term fluctuations in economic growth (so-called structural budget rules) can be effective in forcing a counter-cyclical policy stance. Some developing countries, such as Chile, have been able to manage such fiscal rules successfully.

The establishment of commodity and fiscal stabilization funds could also help smooth out fiscal revenues, such as those based on primary export production. They are by no means a panacea, however, and careful management of such funds is required. One complication is the difficulty of distinguishing cyclical price patterns from long-term trends, in part because of the increased influence of speculative financial investments in commodity markets. This has made it more difficult for Governments to determine the adequate size of stabilization funds. It is therefore important that developing countries also be able to rely on an adequate multilateral system of compensatory financing facilities to protect them against the larger commodity price shocks (see below).

Integrated macroeconomic and development policies

Macroeconomic policies should be supportive of sustaining economic growth and employment-generation. This requires that macroeconomic policies be embedded in a broader development strategy, which was the case for the fast-growing East Asian economies. Fiscal policies would give priority to development spending, including investment in education, health and infrastructure, as well as subsidies and credit guarantees for export industries. As with the experience of East Asia, monetary policy would be coordinated with financial sector and industrial policies, including directed and subsidized credit schemes and managed interest rates, to directly influence investment and savings. Maintaining competitive

exchange rates is considered essential for encouraging export growth and diversification. In contrast, macroeconomic policies in many Latin American and African countries since the 1980s have been focused on much more narrowly defined short-term price stabilization objectives and this has often resulted in exchange-rate overvaluation and unbalanced growth.

Foreign reserve management: reducing the need for "self-insurance"

A common response in many developing countries to the vulnerability associated with sudden stops and reversals of capital flows has been a rapid build-up of reserves. Foreign reserves held by developing countries have climbed, on average, to no less than about 30 per cent of their GDP (with or without China in the sample). Even low-income countries, including the least developed countries, have increased their reserve positions to reduce their debt vulnerability. Reserves went up from 2-3 per cent of GDP in the 1980s to about 5 per cent in the 1990s and to about 12 per cent in the current decade. This has given developing countries a greater buffer or "self-insurance" to cope with external shocks; after the Asian crisis, following speculative attacks on currency-exposed countries, this appeared to be a sensible counter-cyclical strategy.

However, such a strategy carries a high price tag, both directly in terms of the high carry cost of reserves, amounting to as much as $100 billion and representing a net transfer to reserve-currency countries well above what they provide in terms of official development assistance (ODA), and in terms of forgone domestic consumption or investment. The alternative will require a strengthening of regional and global forms of financial cooperation and of macroeconomic policy coordination.

Moreover, for countries that have accumulated large amounts of resources in official reserves holdings and in sovereign wealth funds (SWFs), a small proportion of these could be set aside for development lending. Developing countries own over $4.5 trillion in official reserves and the estimated size of existing SWF assets is at least $3 trillion. Allocating just 1 per cent of those assets (or the equivalent from the asset returns) on an annual basis would amount to about $75 billion, which is triple the size of gross annual lending by the World Bank. Possibly double that development lending capacity could be created if those resources were to be allocated as paid-in capital of development banks.

Multilateral responses

A major challenge for the multilateral financial institutions is to help developing countries mitigate the damaging effects of volatile capital flows and commodity prices and provide counter-cyclical financing mechanisms to compensate for the inherently pro-cyclical movement of private capital flows. A number of options are available to dampen the pro-cyclicality of capital flows, and provide counter-cyclical finance, and thus help create a better environment for sustainable growth.

A first set of measures would include improved international financial regulation to stem capital flow volatility and provision of advice in designing appropriate capital controls, including on a counter-cyclical basis.

At the same time, there is a need for *enhanced provision of emergency financing* in response to external shocks, whether to the current or to the capital accounts, so as to ease the burdens of adjustment and reduce the costs of holding large reserve balances. Current mechanisms are limited in coverage, too narrowly defined, or subject to unduly strict conditionality. International Monetary Fund (IMF) facilities should be significantly simplified and should include more automatic and quicker disbursements proportionate to the scale of the external shocks. Lending on more concessional terms is highly desirable, especially for heavily indebted low-income countries. A new issuance of special drawing rights (SDRs) could be one option for financing a significant increase in the availability of compensatory financing.

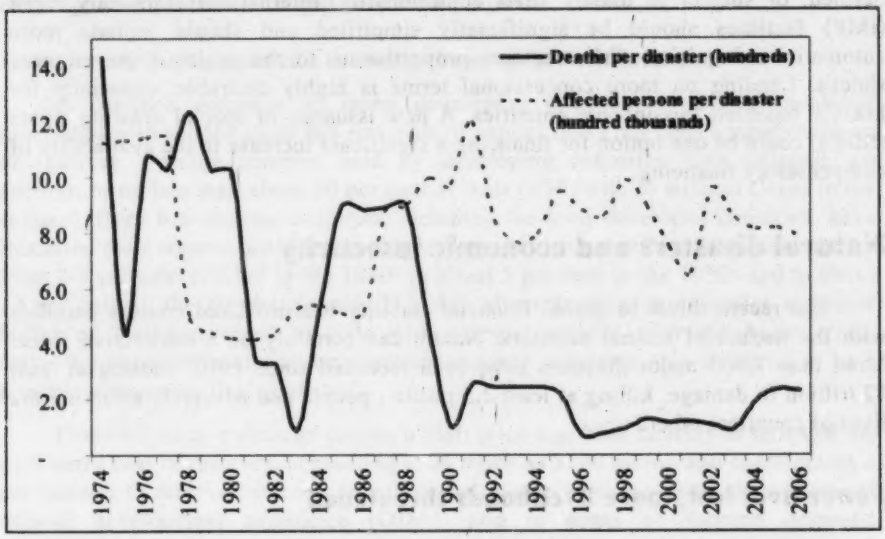
Natural disasters and economic insecurity

The recent threat to global financial stability has provoked endless parallels with the impact of natural disasters. Nature can certainly be a destructive force. More than 7,000 major disasters have been recorded since 1970, causing at least $2 trillion in damage, killing at least 2.5 million people and adversely affecting the lives of countless others.

Fewer lives lost, more livelihoods threatened

Events such as the December 2004 Indian Ocean tsunami are a reminder of the deadly threat of natural forces. Yet, the number of deaths linked to such disasters has been declining, which reflects improved warning systems and more effective food and emergency aid. Other signs, however, are less encouraging: disasters occur more than four times more frequently today than in the 1970s, displacing many more people and costing, on average, almost seven times as much (see figure 0.2). As disasters have become less life-threatening, they have become much more threatening to the economic well-being of the countries and communities hit.

Figure 0.2
Natural disasters are claiming fewer lives, but are affecting the livelihoods of more people
(Five-year moving averages, 1974-2006)



Source: UN/DESA, based on data from the OFDA/CRED International Disaster Database (EM-DAT) (available at www.emdat.net), Université Catholique de Louvain, Brussels.

Precisely what role climate change has played in this trend is difficult to say, though the scientific community has no doubt that the link does exist. The business community is certainly listening. Insurance companies anticipate significant rises in climate-related losses over the next decade, which could top the 1 trillion dollar mark in a bad year.

Death rates from natural disasters are 20 to 30 times higher in developing than in developed countries and the recovery from disasters is much slower in the former. This uneven threat to economic security from natural hazards reflects the difficulties experienced by households, communities and Governments in preparing for them, mitigating their impact and coping with the aftermath.

High rates of poverty, high levels of indebtedness, inadequate public infrastructure, lack of economic diversification, and the like create the structural backdrop for developing countries as they face the threat of natural disaster. Moreover, poor information, inadequate access to finance, ineffective institutions and poor social networks adversely affect resilience, exacerbate impacts and reduce the quality and effectiveness of policy responses. Together, these factors expose poor countries and communities, not just to potentially catastrophic large-scale disasters, but also to frequent smaller-scale disasters which occur seasonally, such as flooding in Bangladesh and windstorms in the Caribbean and Pacific regions.

Under these conditions, families quickly exhaust coping mechanisms such as use of savings and credit, sales of assets and migration, and can be forced into more risk-bearing survival strategies such as the taking out of high-cost loans, which only further perpetuate vulnerability. At the aggregate level, the public response is

compromised by an already low level of public investment, often squeezed by ongoing adjustment programmes. It is only further exacerbated by falling incomes and worsening trade and fiscal balances in the wake of the disaster. The risk is of countries' being locked in vicious circles, as economic insecurity is ratcheted up through fragile food, health and employment conditions which slow recovery and increase exposure to the next hazard.

Dealing with natural disasters

An integrated national policy response

To manage these shocks, households and Governments need better coping strategies. Much attention, particularly by the donor community, has been given in recent years to strategies for pooling and transferring disaster risk and smoothing incomes through market-based financial instruments, such as crop and livestock insurance and catastrophe bonds. At the regional level, some innovative efforts, such as the Caribbean Catastrophe Risk Insurance Facility, have also explored this option.

Such initiatives merit further investigation. However, their impact should not be overstated. Market-based strategies are really a serious option only at higher levels of development where they complement a broad set of mitigation instruments. Insurance is less relevant to countries with underdeveloped financial sectors and within the context of widespread income insecurity. Moreover, the covariant nature of large-scale disasters and their resulting widespread impact can threaten even well-capitalized insurance markets, making these costly options.

The highest priority in managing disasters must be increased investment in preparation and adaptation so as to reduce the risk of natural hazards turning into disasters. Only 2 per cent of disaster management funds are spent by bilateral and multilateral donors on proactive disaster risk reduction, despite the estimate of the United States Geological Survey that economic losses worldwide from disasters in the 1990s could have been cut by some $280 billion through investing $40 billion in disaster risk reduction.

Because disasters may increase food insecurity, preventive measures designed to deal with food vulnerability are likely to be a crucial part of disaster preparedness in many poorer countries. This will require early warning systems, including at the international level, and mapping of food-insecure households classified by degree of malnutrition and deficiencies in food consumption, and active support to small and medium-scale crop agriculture (for example, subsidies to agricultural inputs), as well as cash transfers.

Another effective approach to reducing vulnerability is to link medium-term development strategies to relief activities. A ubiquitous finding from empirical research is that more diversified economies suffer smaller losses from natural hazards and recover more quickly than less diversified economies. For many developing countries, diversification of production is greatly constrained by geographical factors. Still, tailored development strategies will need to move in this direction. A combination of public investment and cheap credit will be an element critical to making progress; but the space within which to implement appropriate industrial policies in support of diversification will also be important.

International insurance and coping mechanisms

For some countries, particularly smaller and poorer rural economies, disasters are often too big to handle. Although the international community is often quick to respond to emergency calls following large-scale disasters, there has been a persistent tendency for delivery to fall short of pledges: funds requested by the United Nations for disasters have consistently failed to reach the desired level.

Multilateral loan facilities, such as the Exogenous Shocks Facility for low-income countries managed by IMF, have been designed to provide assistance for addressing temporary balance-of-payments needs arising from shocks such as natural disasters. However, high levels of conditionality limit their effectiveness. One action that could be quickly implemented to better assist countries affected by disasters would entail introducing a simple mechanism for extending a moratorium on debt servicing through, for example, improvements made to the Paris Club process.

The international community has been moving towards a more integrated strategy for increasing the resilience of vulnerable populations and countries. However, the process has been a slow one. In part, this reflects a wider problem with the aid architecture, including the influence of economic and geopolitical interests.

A global disaster mechanism to mobilize the resources for an integrated risk management approach needs to be established. Initially, such a mechanism could serve as a better means of providing disaster relief, but it should quickly gear up to assume a wider set of responsibilities linked to disaster management. This mechanism could eventually absorb the various facilities that are already in place, but fragmented, with the aim of evolving into a well-funded facility that could not only provide sufficient financing quickly and automatically to countries hit by disaster, but also begin to perform the much more demanding task of investing in disaster reduction for the longer term. Taking the figures from the United States Geological Survey cited earlier as a guide, a $10 billion dollar facility would seem to represent the kind of target that the international community should be aiming for if real progress in reducing this threat is to be achieved.

Things fall apart: civil wars and post-conflict recovery

In some States, increased economic insecurity has become part of a compounding process of deepening social divisions and increasing political instability. Their fragile societies are vulnerable to a multiplicity of threats ranging from natural disasters and food shortages to financial shocks, rising inequality, and badly handled elections, any of which could tip them into widespread, and even genocidal, levels of violence. Under these conditions, the threat exists of the State's losing control, not only of its ability to deliver basic services, but also of its traditional monopoly over the forces of law and order, and ultimately, its hold on political legitimacy.

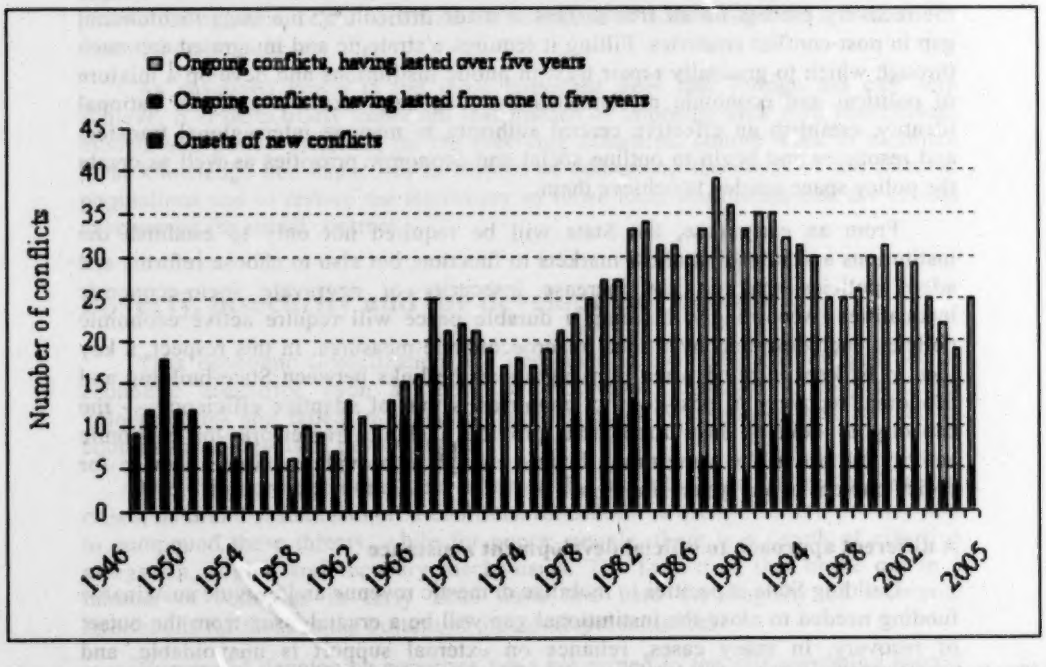
This possibility has changed the face of contemporary warfare over the last three decades. Armed conflicts between States have given way to civil wars fought principally within national borders. These are much more likely to reinforce deep

and cumulative divisions that undermine social cohesion, threaten State norms and institutions, and create a deep sense of fear and distrust among citizens.

Longer and more disruptive conflicts

While each conflict has its own distinct characteristics, the larger picture is one of increasingly protracted and disruptive conflicts concentrated in countries with an annual per capita income of under $3,000; on average, conflicts can last between seven and nine years today, compared with just two or three years in the 1960s and 1970s (see figure 0.3). At the same time (with the pattern being very much like that for natural disasters), there has been a declining number of battle-related deaths accompanied by a larger impact in terms of displaced persons and disrupted economic livelihoods. Serious damage has often been done to the environment, while health crises and hunger are endemic.

Figure 0.3
Conflicts worldwide became more prolonged over the period 1946-2005



Source: UN/DESA, based on UCDP/PRIO Armed Conflict Dataset (2007). Abbreviations: UCDP, Uppsala Conflict Data Programme at the Department of Peace and Conflict Research; Uppsala University, Uppsala, Sweden; PRIO, International Peace Research Institute, Oslo (Centre for the Study of Civil War).

Many of these costs are borne directly at the household and community levels; and along with the destruction and theft of productive assets, they make the recovery of economic and social positions all the more difficult once the fighting has stopped. At the same time, falling incomes, the informalization of economic activity, sharp declines in investment levels and declining fiscal revenues, as well as

a shift in the composition of spending towards military activities, make it increasingly difficult for the State (or what remains of it) to offset these rising costs of the conflict.

As these costs mount, insecurity, capital flight, and the erosion of "social capital" can undermine State institutions and result in conflict traps. The deeply fragile societies that remain after the fighting has ended lack the institutional infrastructure needed to build a new social contract and ensure a rapid and lasting recovery. Not surprisingly, the threat of renewed violence is never very far away: a country with a history of conflict is from two to four times more likely to experience a subsequent war than one without such a history. This possibility adds a distinct dimension to the policy challenge in such countries.

Economic insecurity and post-conflict reconstruction

Closing the institutional gap

Such societies do not have the luxury of meeting the goals of security, reconciliation and development in a measured or sequenced manner, but must begin the recovery process on all fronts. This is made difficult by the large institutional gap in post-conflict countries. Filling it requires a strategic and integrated approach through which to gradually repair trust in public institutions and develop a mixture of political and economic mechanisms that can help create a unifying national identity, establish an effective central authority to manage interregional transfers and resources and begin to outline social and economic priorities as well as create the policy space needed to achieve them.

From an early date, the State will be required not only to establish the institutions and rules that allow markets to function, but also to choose reforms and adopt policies that do not increase insecurity or aggravate socio-economic inequalities. Accordingly, building a durable peace will require active economic policies, including unconventional macroeconomic measures. In this respect, a key idea to be kept in mind when thinking about the links between State-building and economic recovery in post-conflict countries is that of adaptive efficiency — the capacity to develop institutions that provide a stable framework for economic activity but are at the same time, flexible enough to provide maximum leeway for policy choices in any given situation.

A different approach to official development assistance

Building State capacities to mobilize domestic revenue and provide sustainable funding needed to close the institutional gap will be a crucial issue from the outset of recovery. In many cases, reliance on external support is unavoidable, and managing international aid flows will be among the first economic policy tests for both the national authorities and the donor community. However, aid to post-conflict countries often tapers off prematurely and, often, at the very moment when countries have rebuilt institutions and are in a better position to absorb aid and spend it effectively. Steps are being taken by the international community within the context of the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD) and the Peacebuilding Commission to ensure stable and adequate aid flows for sufficiently long periods of time.

Traditionally, donors have preferred to finance specific projects, but particularly in light of the legitimacy deficit faced by States, resources should be channelled through their budgets as far as possible, and every effort should be taken to avoid setting up competing points of authority. In this regard, dual-signature systems designed to approve spending decisions have been found to be effective in addressing both corruption and accountability concerns. Another aspect of the challenge will be the rebuilding of credit and financial markets including through innovative sources of financing.

More equitable public spending

While priorities have to be set by local authorities, both donors and national Governments will need to pay particularly close attention to the links between public expenditure decisions and the grievances that drive the conflicts. Two sets of distributional issues are particularly relevant concerning: (a) how to incorporate equity concerns into spending decisions and (b) how to allocate expenditures across the political landscape so as to bolster incentives for the implementation of accords and the consolidation of peace. Taxation of luxury consumption deserves much more attention from the government side. Conflict impact assessments and peace conditionalities, which seek to calibrate the flow of support to specific peacebuilding steps, could constitute useful means of addressing both sets of issues from the donor side.

As sustained peace is the most important goal that foreign aid can help achieve, it is particularly important that instead of imposing their own institutional models and policy priorities on the receiving countries, donors work to mobilize local knowledge and capacities in respect of addressing the needs of the affected populations and to restore the legitimacy of those local institutions that are crucial to repairing the social contract.

Poverty, insecurity and the development agenda

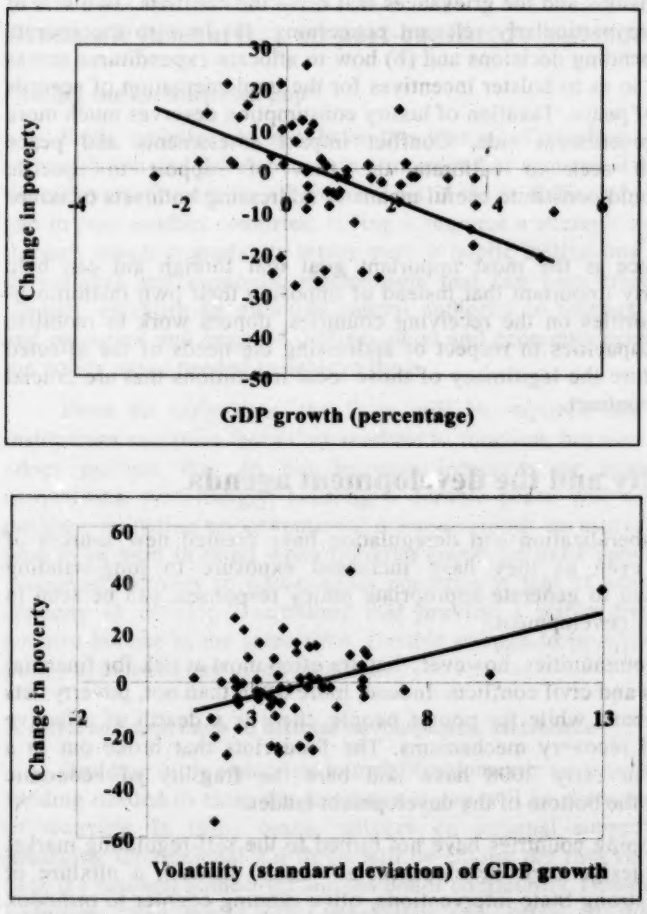
That economic liberalization and deregulation have created new sources of economic insecurity, even as they have increased exposure to long-standing vulnerabilities and failed to generate appropriate policy responses, can be seen in countries at all levels of development.

It is the poorest communities, however, that are often most at risk for financial crises, natural disasters and civil conflicts. Indeed, more often than not, poverty acts to compound these threats, while for poorer people, there is a dearth of effective mitigation, coping and recovery mechanisms. The food riots that broke out in a number of countries in early 2008 have laid bare the fragility of economic livelihoods for those at the bottom of the development ladder.

Successful developing countries have not turned to the self-regulating market for ideas on how to design their development strategies. Instead, a mixture of market incentives and strong State interventions, often running counter to orthodox economic wisdom, has provided the formula for rapid growth. Various economic measures aimed at socializing the risks arising from the undertaking of large-scale investments and adopting unfamiliar technologies have helped nurture a domestic entrepreneurial class. Such support was often guided by a more encompassing development vision which judged policy interventions in terms of their contribution to diversifying economic activity, creating jobs and reducing poverty.

However, growth is a necessary but not a sufficient condition for tackling poverty (see figure 0.4). What is needed is a package of universal social policies and some targeted economic policies tailored to individual country conditions and based on a strong "social contract" designed to secure the spaces within which individuals, households and communities can pursue their interests and make the most effective use of the creative impulses generated by market forces. This requires taking a more integrated approach to economic and social policies and demonstrating a much greater degree of pragmatism in their design and implementation.

Figure 0.4
Increasing growth and reducing volatility help reduce poverty, but they are not sufficient



Sources: UN/DESA, based on United Nations Statistics Division, National Accounts Main Aggregates database, for GDP growth; and World Bank, PovcalNet, available at http://iresearch.worldbank.org/PovcalNet/jsp/index.jsp.

Note: Change in poverty is measured as a percentage point change in the incidence of poverty for the $1 per day poverty line, over the period 1981-2004.

Dealing with household economic insecurity

Pro-poor macroeconomic and growth policies

For most developing countries, poverty and the insecure livelihoods that it breeds can be tackled only through sustained rapid growth and expansion of formal employment. In many cases where rural growth is likely to reduce poverty faster than urban growth, agriculture — neglected in policy advice in recent decades — needs to be the focus of increased support, including for small farmers. However, with the general pace of urbanization accelerating, labour-intensive manufacturing and a more sophisticated service sector will also need to be encouraged if poverty is truly to become history. As seen in the cases of natural disasters and civil conflict, economic diversification remains among the most successful means to insure against insecurity.

Pro-poor macroeconomic policies certainly need to be included in the mix for tackling chronic levels of insecurity. In many developing countries where agriculture is still a principal source of income and export earnings, policies will be aimed at managing "commodity cycles", as these tend to hit the poorest particularly hard on the downside. Stabilization funds will have a role to play in this task.

Competitive and stable exchange rates along with low and stable real interest rates will also be part of the mix, often requiring delayed capital-account liberalization and the measured use of capital controls. Stable fiscal revenues are also essential, particularly for filling the infrastructural gaps which are a major constraint on growth in most poor countries.

Finance and insurance for the poor

Innovative sources of finance have a role to play in tackling the poverty-insecurity nexus. In recent years, microfinance has become the policy of choice, particularly among the donor community, for encouraging enterprise and tackling poverty. An initial interest in microcredit has expanded to include microsavings and microinsurance. This has produced some positive social outcomes, particularly in alleviating poverty among women. However, these activities still constitute a very small part of the financial sector in most countries, and often fail to generate significant productive employment. The poorest communities therefore remain vulnerable to systemic shocks. In this regard, Governments must examine the situation closely to determine whether the subsidies used to support these schemes are the best means of tackling poverty or whether other mitigation and coping strategies might provide a more suitable response.

Welfare programmes and social protection

Such strategies come in various forms. These range from workfare programmes, which have been in place in many countries for a long time, to cash transfer programmes, which have become popular recently. While most of these programmes were originally launched and used as ex post measures to help affected people cope with economic downturns, in more recent years they have been increasingly used as ex ante measures to reduce the exposure of the poor to insecurity. For example, India has recently adopted a workfare scheme that guarantees 100 days of employment in a year to all those who wish to participate —

an example of workfare's being transformed from a post-shock temporary arrangement into a semi-formal permanent employment scheme.

A similar transformation of arrangements from ex post to ex ante is exemplified by cash transfer programmes used to promote specific development objectives, such as school attendance by children and use of health services. Just as budgetary support has become a more popular form of providing aid at the macrolevel, so has provision of cash become a more popular form of social protection at the household level.

A perennial issue with respect to the design and implementation of such measures is whether they are best pitched as universal policies or as policies specifically targeted at the poor. Although the trend in recent years has been towards the latter approach, this has not achieved the right balance. The fact that, in general, universal systems have a better track record in eliminating poverty reflects the combination of a better income distribution (with potentially stronger growth dynamics), a broader political appeal, particularly with support from the middle classes, and some clear administrative and cost advantages.

Back to the multilateral drawing board

The simple message conveyed by this year's *Survey* is that markets cannot be left to their own devices in respect of delivering appropriate and desired levels of economic security. This should not, however, be taken as promoting an agenda for the abandoning of market forces; in this case, the agenda is rather one of making security and cohesion the basis for the unleashing of the creative impulses generated by those forces. Just what combination of regulation, mitigation, protection and relief is required will depend on the kind of threats being faced, and on the local capacities and resources that can be mobilized, as well as on local preferences and choices. However, when dealing with the kind of systemic shocks under discussion, there is likely to be a particularly prominent role for the international community.

Strengthening that role is a matter less of inventing new modalities than of returning to the principles of multilateralism that were prematurely abandoned through a misplaced faith in self-regulating market forces. Those principles had been fashioned at a time when the threats to security arising from operating in an interdependent world economy were more firmly grasped by policymakers than has recently been the case. The international community should consider:

- **A renewed Bretton Woods.** Much as in the interwar years, leaving the management of cycles to flexible labour markets and independent central banks has not proved successful. A singular focus on price stability has not contained asset-centric boom-bust cycles, even as it has pushed employment objectives and a healthy balance between wages and productivity growth off the policy agenda. Counter-cyclical macroeconomic measures and financial regulation need to be revived. Achieving this means that the international financial architecture can no longer continue to be organized around the principle of laissez-faire, which has extended the global reach of financial markets without establishing matching global rules, resources and regulations. Filling that gap is an urgent priority.

The process should begin with a reconsideration of the level and terms of access of developing countries to IMF resources, especially compensatory financing mechanisms designed to assist in coping with external shocks. It is also important to eliminate the tendency to impose pro-cyclical macroeconomic conditionality at higher access levels. Improved multilateral surveillance will also need to take account of all possible international spillovers of national economic policies.

- **Revisiting the Marshall Plan principles.** A more effective aid architecture is needed, especially for countries vulnerable to natural disasters and those recovering from conflict. Meeting the long-standing target for ODA of 0.7 per cent of the gross national income of DAC members is important, but it will not be sufficient. Current arrangements lack a proper framework of organizing principles through which to encourage and complement domestic efforts at resource mobilization, one that is consistent with local priorities and capacities, and supports the recipient Government's own development priorities and strategy.

  The benchmark for aid effectiveness was set over 60 years ago by the Marshall Plan, and while the times and the challenges have changed, the principles for coordinating national development plans with international assistance remain germane. These include, in particular, front-loaded and generous support for national development priorities, unburdened by excessive conditionality and donor demands, and attuned to national constraints and sensibilities.

- **A Global New Deal.** Much like focusing on the Marshall Plan, invoking a "new deal" has become part of today's development policy debates. The recent food security crisis has led the World Bank to plead for a new deal on global food policy. The operation of market forces should, through further agricultural trade liberalization, more compensatory financing and strengthened social safety nets, strike the right balance as regards the interests of food importers versus those of food exporters. However, these recommendations underemphasize some of the key elements of President Roosevelt's original New Deal developed in response to the Great Depression, in particular the mechanisms that were created to expand and better manage markets, along with redistributional measures aimed at better distributing the burden of shocks.

  Just how far the redistribution agenda can be pushed towards rebalancing globalization and preventing a potentially damaging backlash is a subject open to debate. One suggestion entails a minimum basic income in the form of a cash grant to all households, which picks up and extends the idea of a basic pension as proposed in the 2007 *World Economic and Social Survey*. Such measures are, of course, fraught with complications and difficulties. And asking at what level and with what resources this could be pursued as part of a wider security agenda remains an abstract policy point. Still, there are interesting precedents: the State of Alaska has been implementing such a measure since the early 1980s and there are similar initiatives elsewhere. More recently, United Nations organizations have begun examining the concept of a "global social floor" designed to provide a minimum level of security in line with the principles of the Universal Declaration of Human Rights. This serves

as a reminder that in an interdependent world, social cohesion is not a luxury, but rather a necessary component of a healthy and vibrant system.

Against the growing backdrop of increasing economic and political insecurity in interwar Europe, John Maynard Keynes called for "new policies and new instruments to adapt and control the workings of economic forces, so that they do not intolerably interfere with contemporary ideas as to what is fit and proper in the interests of social stability and social justice". Those words resonate just as strongly today. The responsibility for the choice and mix of policies required to guarantee prosperity, stability and justice, remains, of course, with national institutions and constituencies, but in an increasingly interdependent world and on a fragile planet, building a more secure home is a truly international endeavour.